Free Trade Areas, The European Experience

What Lessons for Canadian-U.S. Trade Liberalization?

Observation No. 31
C.D. Howe Institute

Victoria Curzon Price

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Foreword

When Canada and the United States embarked on negotiating a free trade agreement, the C.D. Howe Institute undertook to study the lessons to be learned from Europe's experience with establishing regional free trade areas. In this study, Professor Victoria Curzon Price, of the Graduate Institute of European Studies, University of Geneva, reviews the obstacles to free trade Europeans have faced and the progress they have made in overcoming them. She presents a constructive framework for Canadians and Americans to consider as they work toward the goal of free trade.

For the past 40 years, the members of the European Free Trade Area (EFTA) and the European Community (EC) have pursued a dual trade strategy. This strategy combines regional free trade with membership in, and a commitment to, the multilateral trading system. Professor Curzon Price documents the genesis and development of EFTA and the EC and the evolving relationship between the two trading groups. She illustrates the complex and multidimensional nature of regional free trade, and the challenge of dispute settlement within a free trade area.

The European experience offers several key lessons that clearly would help Canada and the United States to benefit from the gains from free trade while minimizing potential conflicts:

- One of the reasons for the success of free trade areas in Europe has been the decision to limit the scope of the arrangements to certain sectors. Free trade negotiations initially focused on sectors where agreement was possible and success likely; consequently, most progress in freeing trade in Europe has occurred in the industrial goods sectors.
- Europeans learned that it was difficult to achieve free trade in sectors where extensive nontariff barriers were already in effect. This suggests delaying negotiations on highly regulated sectors unless it is clear that each country's regulatory policies are quite similar.
- Allowing adequate time for transition and adjustment helps to avoid unnecessary trade disputes by facilitating the process of structural adjustment. Settling the disputes that do arise needs to be pursued as a continuous process. In Europe, because it has been

an ongoing process, formal dispute settlement procedures have been required only rarely. The European experience indicates, however, that the smaller parties in a free trade area may find a "second stage" — for example, an impartial, quasi-judicial body — desirable for settling disputes. Canada and the United States also may find such a mechanism attractive because it would help to depoliticize disputes.

- In Europe, most trade disputes have concerned nontariff barriers. To avoid such disputes, rules that establish a "level playing field" for all partners in a free trade area could assist materially.

The study draws three important implications for Canadians:

- First, free trade requires the acceptance of competition as a basis for promoting efficiency to build a more internationally competitive country. This challenges Canadians to ask themselves what kind of economy they wish to bequeath to the next generation.
- Second, economic integration can be achieved without serious loss of political and cultural sovereignty. Canadians thus must decide how much integration they desire.
- Third, the process of adjustment to free trade can lead to substantial benefits in the longer term, and it can be managed so that it is not traumatic even in the short term.

It is evident from Professor Curzon Price's analysis that Western Europeans have worked through in a practical way many of the problems that Canada and the United States are currently considering in principle. To be sure, Europeans have further progress to make in freeing trade, but it is important to understand that Canada and the United States are not about to set forth down an unblazed trail. The two countries are at a crossroads; the decisions they make now will determine how they will journey into the next century.

The manuscript was prepared by Cordelia Sharpe and edited for publication by Barry A. Norris. As with all Institute publications, the conclusions are those of the author and do not necessarily represent the views of the Institute's members or directors.

Maureen Farrow
President
September 1987

Preface

Canada and the United States are currently exploring the possibility of forming a free trade area. Viewed from Western Europe, at least in the eyes of this observer, this initiative is long overdue. The countries of Western Europe — whether they are members of the European Community, or of its much smaller counterpart, the European Free Trade Association (EFTA) — have for many years pursued the dual trade strategy permitted by Article XXIV of the General Agreement on Tariffs and Trade of combining regional free trade with membership of and commitment to the multilateral trading system. This dual strategy, which ensures that the level of external protection of regional groups is kept low, virtually guarantees substantial welfare gains to participants. As these gains feed into higher real incomes, even outsiders — who lose out from trade diversion — enjoy a "dynamic" gain from trading with more prosperous partners. In this sense, regional free trade and multilateral freer trade are complementary and not, as is often thought, conflicting trade strategies.

What, if anything, can be learned from the European experience of this dual approach? In this study, the aim will be to highlight the factors that seem to be relevant to the Canadian-U.S. context, while leaving the facts to speak for themselves. The perspective is that of someone who is familiar with the European experience, but who is conjecturing about which parts of that experience may be directly relevant to the Canadian-U.S. case.

Having said this, one general contrast between the European experience and North American projects for economic integration stands out quite clearly. While Europe has been edging gradually toward greater integration over a period of 40 years, rather like a swimmer entering a cold pool at the shallow end, North Americans seem to be about to plunge straight in at the deep end. Whereas Europeans carefully avoided many of the contentious problems, dealing with them partially (or not at all) and sequentially over a long period of time, Canadians and Americans seem to be heading for an ambitious all-or-nothing solution. It should be kept in mind, in view of the inherent dangers of this approach and the potential for disappointment that might arise from a less than perfect accord on

all issues, that there are many intermediate situations and that economic integration is best viewed as a lengthy evolutionary process.

This analysis of Europe's experience with free trade areas is divided into three chapters. The first chapter discusses the evolution of EFTA, its contribution to freer trade in Western Europe, and the reasons for its achievements and failures. Chapter 2 analyzes the operative rules that govern both EFTA and the free trade agreements between EFTA and the European Community and that would be technically necessary in any free trade system linking market economies. The concluding chapter presents possible lessons for Canadian-U.S. freer trade.

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The Emergence of Free Trade Areas in Europe

Western Europe by now has over 130 country-years of experience in operating free trade areas: 28 years for the European Free Trade Association (EFTA), which was founded in 1960 and is still in existence, 14 years for the bilateral free trade agreement that linked Portugal to the European Economic Community (EEC) from 1972 to 1985, and 15 years each fo. the six other bilateral free trade areas that link the members of EFTA to the Common Market. What complexity surrounds as apparently simple a concept as that of creating a mere free trade zone among "consenting adults"! There is obviously more to creating free trade areas than meets the eye.

The flock of seven free trade areas currently in existence in Western Europe covers some U.S.$75 billion worth of intra-European trade — not very much in relation to a grand total of U.S.$500 billion for the continent as a whole, but vital for the six small countries that have chosen this form of economic integration with their giant neighbor, the EEC. The latter, in 1985, took 53 percent of their exports and provided 58 percent of their imports.

This level of dependence on a single market is further enhanced by the fact that the EFTA members, like all small developed countries, have very high rates of foreign trade dependence in general. In 1985 they exported, on average, U.S.$3,400 for every man, woman, and child, compared with U.S.$2,000 for the EEC and U.S.$860 for the United States. In this respect they resemble Canada, which recorded an even higher rate of general trade dependence (U.S.$4,250 worth of exports per capita) and an even more impressive level of concentration on a single market (78 percent).

These geo-economic facts explain the single-mindedness with which the small EFTA countries have pursued their relationship with the EEC.

The original EFTA group was formed as a reaction to the formation of the EEC. It was composed of a group of countries that had no stomach for the highly intensive form of economic integration

on which the EEC was preparing to embark. They wanted to keep a free hand, not only in trade policy, but also in what is nowadays called, for want of a better term, industrial policy.

The Treaty of Rome, which created the EEC, was an ambitious document, not only in its scope but also in its institutional structures. Joining it had far-reaching political implications, even if the objective of European union was not explicitly mentioned. It implied the pooling of sovereignty in such sensitive fields as external trade policy, agricultural policy, immigration policy, and, potentially, social, monetary, and fiscal policy as well. In addition, the Treaty of Rome pioneered a new *form* of international cooperation: decisiontaking by majority vote in certain specified circumstances. As if this were not enough, it also provided for the harmonization of laws "to the extent necessary" for the proper functioning of the Common Market (Article 100). Finally, it gave a unique role to a semi-independent commission to promote the general EEC interest by proposing new steps in integration matters. Seen from an unbeliever's point of view, the EEC looked like a dangerously open-ended affair.

In the 1956–59 period, the future EFTA countries, for various reasons, were not prepared for anything like as ambitious a program, although some of them later changed their minds. On the other hand, they were loath to see their main markets and competitors combining and locking them out. Their main policy objective was, therefore, to negotiate a European-wide free trade area within the framework of the Organisation for European Economic Co-operation (OEEC) — precursor of today's Organisation for Economic Co-operation and Development (OECD) — embracing both themselves and the nascent Common Market.

To begin with, however, the EEC was insecure. There were huge "loss of sovereignty" costs associated with joining. To offer the unbelievers what they wanted — free trade in industrial goods only — was a soft option that existing and prospective members of the EEC might find tempting. The whole enterprise might be placed in jeopardy. In the words of General de Gaulle, the EEC might dissolve "like a lump of sugar in a cup of tea" and end up as a loose free trade area. This is just what the United Kingdom had in fact proposed in 1956, but it was an initiative the founding fathers of the EEC viewed at the time as no less than willful sabotage.

For ten years, the outsiders had no option but to develop their own (limited) economic integration scheme, based on the free trade area concept, and to hope for the best.

The breakthrough basically came because the United Kingdom not only decided to throw in its lot with the EEC but also finally succeeded in gaining admission after a humiliating ten-year wait. With the United Kingdom inside, the EEC contained all the larger countries of Western Europe — except for Spain, at the time a pariah under Franco and not a factor in this particular episode. It could at last afford to be generous with the odd assortment of little countries that still wished to remain outside. They were about to realize their long-standing aim of combining a maximum of independence from the EEC with a maximum of trade access to it — a first-best solution, in their eyes, and one that, in practice, only small countries could hope to get away with.

It was no accident that the form taken to integrate these small countries with the EEC should be a series of free trade areas. A customs union between the EEC and EFTA would have been out of the question for both sides, neither of which wished to abandon sovereignty in external trade policy matters. The only alternative compatible with the General Agreement on Tariffs and Trade (GATT) was a free trade area.

The simplest solution would have been for the EEC to join EFTA, as a unit, thus creating a single, multilateral free trade area covering the whole of Western Europe, with a concentrated core — the EEC customs union — at its center. This was not to be, however. The EEC was still worried about the dissolution issue, quite apart from the fact that in a greater-EFTA context, it would represent only one sovereign entity among several. In such a setting, its sheer economic weight would lose some of its power to influence policy outcomes since, technically speaking, it would be on an equal footing with Finland, Switzerland, or even tiny Iceland. This being obviously quite unacceptable, the EEC proposed the negotiation of bilateral free trade areas with individual EFTA countries.

This solution, first mooted in 1971, still governs the relationship between EFTA countries and the EEC and is likely to continue to do so for many years to come. Even if there are further transfers of membership — such as Portugal's — from EFTA to the EEC, the gradual sorting-out process whereby various European countries decide which form of economic integration best suits them

will still result in a handful of countries remaining outside. Some countries are simply too attached to their own peculiar way of doing things, their own conception of what it means to be Swiss, Swedish, or whatever, to wish to be drawn into the vortex of the European Community. Besides, they have a fantastic "deal": guaranteed access to their principal export market based on conventional reciprocity — no more, no less.

EFTA's Formation and Early Years

The Stockholm Convention

The European Free Trade Association's constitutional document, setting out its members' rights and obligations and their joint objectives, is known as the Stockholm Convention. It was signed in January 1960 by seven countries — Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. It came into force in May of the same year and the first tariff reductions were made according to schedule on July 1, 1960. In 1961, the original seven were joined by Finland, which became an associate member.

The Stockholm Convention contains only 44 Articles, most of which are brief and can only be described as setting forth certain guiding principles. The only areas in which the Convention goes into any detail are the provisions for tariff reductions and the elimination of quantitative restrictions (Articles 3 to 11), and the rules of origin, which are annexed to the Convention and form an integral part of it.

The basic objective of the association is contained in the Preamble. Surprisingly, it is *not* to create a free trade area among its members but to "facilitate the early establishment of a multilateral association for the removal of trade barriers and the promotion of closer economic co-operation between the Members of the Organisation for European Economic Co-operation, including the Members of the European Economic Community." In other words, the creation of a free trade area among the seven EFTA signatories was a means to an end, rather than an end in itself. In fact, nowhere is it explicitly mentioned; it is only implied in the opening sentence of Article 3: "Member States shall reduce and ultimately eliminate...customs duties and other charges with equivalent effect...." The rest of the document then goes on, essentially, to

develop this statement, dealing first with industrial goods, where mutual rights and obligations are far-reaching, then with agriculture and fisheries, where they are less so.

It is recognized that the removal of tariffs and quantitative restrictions does not, by itself, create a free market, and perhaps one of the most interesting and innovative aspects of the Stockholm Convention is to be found in the so-called rules of competition (Articles 13 to 17), which contain EFTA's approach to the problem of nontariff barriers.

Four escape clauses are provided: a general "public health and morality" exception in Article 12, a national defense and security exception (Article 18), a classical but nowadays superfluous balance of payments escape clause (Article 19), and a "contingency" clause dealing with difficulties experienced in particular sectors as a result of the progressive elimination of tariffs (Article 20).

Brief mention is made of the importance of "invisible transactions and transfers" (Article 29) and of the economic and financial policies of member states (Article 30) but mainly by way of reserving these to the domain of national sovereignty. The remainder of the Convention is taken up with institutional matters and provision for an agreed consultations and complaints procedure.

Freeing Intra-EFTA Trade: The Initial Phase

The first years of EFTA's existence were taken up with an almost schizophrenic alternation between the pursuit of its primary objective — the creation of a European-wide free trade system embracing over 300 million people — and the achievement of its supposedly concordant objective of creating a free trade area among its members. In the event, these two goals turned out to be incompatible during EFTA's initial phase.

The first tariff cut of 20 percent, scheduled for July 1960, was awaited with interest and some apprehension. It was carried out without difficulty, as were its successors, the whole process being put on an automatic footing according to a pre-agreed timetable. But the very ease with which the dismantling of tariffs among the seven EFTA countries and Finland was taking place brought the problem of the growing rift between EFTA and the European Community ever more painfully to the fore. Much time in EFTA was spent discussing possible multilateral "bridges" to be built between

the two integrating groups. These discussions were almost completely academic, and EFTA's overtures to Brussels fell on deaf ears. By 1961 the U.K. government, for one, concluded that this approach was fruitless and decided to leave EFTA to apply for full membership in the EEC.

This, in effect, was a denial of EFTA's potential role in promoting a *multilateral* solution to the problem of European integration. For two years EFTA virtually ceased to function, as the United Kingdom, Denmark, and Norway each applied individually to join the EEC, leaving their neutral partners to find their own bilateral solutions to trade with the Community.

General de Gaulle's famous January 1963 veto of U.K. membership put an end to this "bilateral" phase and brought EFTA back to life, this time with only one objective: to create a viable free trade area among its members. The longer-term goal of working toward a single European market was shelved. From 1963 onwards, EFTA concentrated its energies on developing a free trade area prototype that ultimately formed the basis for the merger of the two regional integration schemes when, in December 1969, the EEC at last decided that the time had come to re-examine the question of enlargement.

Exclusions from the Stockholm Convention

The original EFTA group could not have contained an odder assortment of countries. Some were highly industrialized (Sweden, Switzerland, and Austria); some had resource-based economies (Norway and Finland); one had an agriculturally based economy (Denmark); there was a comparatively backward economy (Portugal); and an excolonial power (the United Kingdom). Politically speaking, they ranged from being committed to a policy of neutrality and noninvolvement in any form of military alliance to being a nuclear power member of NATO. They were not even all geographically contiguous, a factor that undoubtedly helped to keep relations on the whole cordial. The basic organizing principle that brought them together was their jointly held conviction that a meaningful level of economic integration could be achieved without much bureaucracy, without much harmonization, and without loss of sovereignty or identity.

It followed, therefore, that they developed an almost homeopathic model of economic integration. To this day, the EFTA Secretariat

employs no more than 67 people — compared with some 18,000 for the European Community — and operates on a correspondingly miniscule budget. To explain this amazing contrast, it is perhaps best to describe what EFTA does *not* attempt to do, before discussing its achievements.

Agriculture

The first major exclusion was agriculture. This was a managed sector in most, if not all, EFTA countries. To subject it to free trade would have put the different farm policies of the group into competition with each other. The distortions would have been monumental, quite apart from the fact that none of the members wanted to change its way of supporting its farmers.

In the EEC, by contrast, from the instant its members agreed that agriculture should be included, the joint formulation of agricultural policy for the group as a whole was *necessarily* implied. A managed sector to start with, agriculture has remained a managed sector in the EEC to this day. One cannot speak of its being opened up to "free trade", nor of its being subjected to the rigors of competition, even within the EEC itself. All is managed from the center, and it has escaped nobody's attention that this is the hard way to "integrate" — a great deal of effort for precious little, if any, integration in the real sense of the word, namely, trade based on specialization according to comparative advantage.

The EFTA countries simply side-stepped this thorny issue by creating a free trade area for industrial goods only. Since intra-area trade in farm products accounted for only 10 percent of the total, they assumed that the remaining 90 percent complied with the GATT rule that the free trade area should cover "substantially all the trade" within the group. This assumption was never formally tested in the GATT, but it passed into the realm of accepted precedent when the Contracting Parties to the GATT "took note" of the provisions of the Stockholm Convention on November 18, 1960.

The exclusion of agriculture, however, was not to everybody's liking. Denmark, Norway, and Portugal, in particular, relied on agricultural or fisheries products for a comparatively high proportion of their exports. In Denmark, for example, agriculture accounted for 69 percent of its exports as late as 1952, and by the time the Stockholm Convention was negotiated, in the late 1950s, it still comprised

50 percent. As a result of Danish insistence, the EFTA Convention contained the following provision: "the objective of the Association (in relation to agricultural goods) shall be to facilitate an expansion of trade which will provide reasonable reciprocity to Member States whose economies depend to a great extent on exports of agricultural goods" (Article 22). However, the Convention did not specify in any way how this objective was to be achieved. In the end, it was up to Denmark to negotiate a series of piecemeal bilateral treaties that afforded tariff-free treatment for a few carefully defined products — such as bacon, blue cheese, and tinned cream — in carefully defined markets and often for carefully defined quantities: veritable epitomes of managed trade agreements.

As long as Denmark remained a member of EFTA, agriculture took up a disproportionate amount of time in EFTA councils. It was always a contentious issue, since the Danish felt that they had not been given "reasonable reciprocity", while their partners were already highly impressed by their own generosity.[1] On Denmark's departure, agricultural problems receded, only to be replaced by fish when Iceland joined the group. The problem here, however, is much less acute since among EFTA's current members, one not only finds great fish producers but also landlocked countries that, by definition, have to import 100 percent of their fresh seawater fish requirements. Iceland and Norway continue to press for complete free trade in this respect and raise the issue regularly in the EFTA Council, so far to no avail — Switzerland and Austria presumably have no wish to antagonize the fishermen of the entire European Community for the sake of their Nordic friends. The issue is more one of principle than anything else, however, since these EFTA countries do in fact pursue liberal policies with respect to imports of fish.[2]

In contrast to their reluctance to do much to promote freer trade in basic food products, some EFTA countries had a definite interest in promoting freer trade in processed food products, such as biscuits, chocolates, and tinned or frozen foods. Here, lists of processed foods were established (under Protocol II) where the industrial element was included in the free trade area regime and members agreed

[1]For these and other details concerning this long-forgotten aspect of EFTA's early existence, see Victoria Curzon Price, *The Essentials of Economic Integration: Lessons of the EFTA Experience* (Basingstoke: Macmillan, 1974).

[2]See European Free Trade Association, Secretariat, *The European Free Trade Association* (Geneva, 1980), pp. 70–71.

only to adjust at the frontier for differences in the prices of the raw material inputs.

The only conclusion that can be drawn from this experience is that it seems wise to avoid including agriculture explicitly in a free trade regime. Where price levels are not determined by market forces but by government policy, one must aim either for a joint agricultural policy or for a certain amount of managed trade on a reciprocity basis. Both courses are fraught with potential tension, since the decisionmaking process is governmental and, hence, automatically politicized. If a member of a free trade area is *disproportionately* concerned with securing markets for its agricultural exports, however, the matter is bound to surface, promising to provide diplomats with many extra hours of hard work.

Free Movement of Labor and Capital

EFTA's second major exclusion, by comparison with the EEC, was the fact that the Stockholm Convention made only limited provision for the movement of labor and capital. Most members applied stern exchange controls on capital movements, both into and out of their countries. They were equally severe when it came to immigration. The Swiss and the Scandinavians, in particular, felt and, indeed, still feel that the free movement of people — which was provided for in the Treaty of Rome — might become a threat to their national and cultural identity. They were equally anxious to prevent foreigners, whether physical or corporate, from acquiring control of important local enterprises or even from buying real estate.

Among EFTA members, this control over the inward movement of labor and capital was, and still is, deemed essential to the preservation of their cultural identity. The feeling is amazingly strong in Scandinavia, where one would have thought that cultural identity is not under threat from anywhere. It is equally strong in Switzerland, with somewhat more reason, for this little country is, after all, composed of three major cultures, each of which has a tendency to be pulled toward France, West Germany, or Italy, as the case may be.

When all is said and done, it is this cultural issue that forms the largest stumbling block preventing these countries from one day joining the European Community. Their own way out of the dilemma that this poses for them is to say, in effect: "free movement of

goods and possibly services (including financial services), yes; free movement of labor and direct investment, no."

The Stockholm Convention reflects this attitude faithfully. It allows for limited rights of establishment and operation of economic enterprises. Article 16 is drafted in a tortuous double negative form, suggesting that it was a difficult matter to negotiate: members "recognise" that "restrictions on the establishment and operation of economic enterprises in their territories by nationals of other Member States should not be applied...in such a way as to frustrate the benefits expected from the removal or the absence of duties and quantitative restrictions on trade between Member States." To say that "restrictions...should not be applied" is quite different from saying that establishment, under certain circumstances, is to be allowed insofar as necessary for the attainment of the objectives of the Association, which could have been an alternative formulation!

It is worth noting that the right of establishment in EFTA is strictly limited to "the benefits expected," namely, intra-area trade. Since the Stockholm Convention does not include agriculture or services — for the moment — but only covers trade in manufactured goods, firms or people wishing to avail themselves of this right have to demonstrate that establishment is necessary for the promotion of intra-area trade in manufactured goods. This "mini" right of establishment is a valuable element. It stops short of guaranteeing a full "right of direct investment," which would not have been acceptable to members, but it does recognize that some physical establishment for the purpose of trade is useful to economic agents and that obstacles to such establishment could act as a subtle form of nontariff trade barrier.

Finally, it should be noted that Article 16.5 voices some of the fears that underlie the whole issue:

> Nothing in this Article shall prevent the adoption and enforcement by a Member State of measures for the control of entry, residence, activity and departure of aliens where such measures are justified by reasons of public order, public health or morality, or national security, *or for the prevention of a serious imbalance in the social or demographic structure of that Member State* [emphasis added].

EFTA members reviewed the operation of this Article once, in 1966. On that occasion, they confirmed that the objective was not

free establishment but treatment "no less favourable" than that granted to nationals — and this only to the extent that discrimination could be shown to "frustrate the benefits" and so forth. In other words, discrimination against foreigners was possible as long as it did not "frustrate the benefits." They established lists of types of enterprises that could, in principle, hope to fall within the scope of the Article, and they agreed that borderline cases should be "dealt with in a spirit of co-operation."

In practice, no case exists of a conflict having arisen in connection with the application of Article 16, or at least none has transpired from the discreet and low-key EFTA Council.

In the case of physical persons, it was agreed in 1966 that Article 16 only applied to "directors and managing directors as well as key personnel." Subordinate staff "not considered essential" did not come within the scope of the article.

Today, some 20 years later, the EFTA countries show no signs of dissatisfaction with these provisions.

Services

The third major area excluded from the Stockholm Convention is services. It is not that the founding members had strong feelings in this regard. Rather, they thought that existing provisions were adequate, and they agreed to review their mutual obligations at a future date if they ever felt that a change might be indicated. So far, they have not done so, although they are showing a keen interest in the European Community's program to create a free market in services by 1992 and thus live up to the provisions of the Treaty of Rome. It will be recalled, in this connection, that the Treaty of Rome provides for the free "movement" of goods *and* services. To the extent that one is referring to tradable services — such as insurance, financial services, consulting, data processing — the EFTA countries would have no difficulty joining an across-the-board liberalization process, whether on a regional or a multilateral basis. But factor services are another matter. Since they cannot be dissociated from the person providing them, the freedom to provide the service implies the free movement of the person as well, and we are back to the problem of immigration discussed above.

Understandably enough, the question of services received but scant attention in EFTA itself, although it has become a live issue

in the EFTA-EC context. Some of the dilemmas that EFTA could sidestep by just ignoring them because of the small scale of its operations are now beginning to show their horns.

Institutional Structure

Having avoided the really contentious issues — such as agriculture, inward investment, and immigration — and having chosen merely to eliminate tariffs on intra-area trade in goods, EFTA's institutional structure could afford to be slim. Unlike the Treaty of Rome, which establishes elaborate common institutions and an impressive judicial arm, the Stockholm Convention establishes only one: the Council. Each member is represented on the Council and decisions have to be taken unanimously. Much is made in EFTA folklore of the fact that formal voting hardly ever takes place. Matters are thrashed out until a common view is developed — or sometimes they are just abandoned because a common view fails to emerge.

The Council is the governing body of EFTA, providing a forum in which the members consult, negotiate, and act together. It meets at the level of either ministers or officials. Ministerial meetings, attended by ministers of trade or foreign affairs, are held twice a year, while meetings of officials usually take place once a week. These meetings are prepared by the deputies of the heads of permanent delegations, who meet a couple of days before the Council does to discuss the agenda and to bring each item as near as possible to the point where the Council itself can take a decision. In short, the EFTA Council is a forum for continuous discussion and negotiation.

A conventional consultation and complaints procedure is established under Article 31 of the Convention, but is seldom used. In fact, members are expressly encouraged to try and find their own solutions to problems, as and when they arise, and to come to the Council for a ruling only if bilateral talks fail. In its entire existence, the formal consultations and complaints procedure has only been used six times, the last in 1967. It normally involves the establishment of an Examining Committee, a formal report therefrom, and a final (nonbinding) recommendation by the Council, whose mandate is to propose a solution to the problem. In only two cases did the parties to a dispute adopt a Council recommendation. In other cases, the dispute either petered out, or was solved bilaterally before the Council reached its conclusions, or, in one famous case,

remained blatantly unresolved — the Council decided not to decide, but to "follow developments."[3]

In practice, an informal method of handling disputes has grown up. A member will question the legality of this or that subsidy, import deposit scheme, or administrative practice indulged in by another member. The matter will be discussed in the Council, and perhaps referred to a standing committee with particular competence in the field.

The Council's mandate, first and foremost, is to look at the *practical trade effects of the measure being questioned* and only later to review its legality. In part, this approach is understandable, because many government measures in use today were not even dreamed of in 1959, when the Stockholm Convention was being drafted. Thus, such measures are not expressly prohibited and their legality, or lack of it, can be debated at great length. However, this primary emphasis on practical effects rather than on legal status also coincides with EFTA's predilection for "pragmatism" — another of the ways in which it keeps its institutional structure as lightweight as possible. During the difficult 1970s at least, the end result of this informal procedure appears to have been to accept these doubtful practices "temporarily".

One can only emphasize that this relaxed way of handling what, after all, can be very serious matters is only possible given EFTA's small size and its lack of importance in trade-volume terms, even for its own members. Thus, if Sweden, for instance, decides to subsidize some of its industries to preserve employment, this may indeed hamper some EFTA exporters, but not to any dramatic extent — hence, the emphasis on practical effects rather than on legal issues. However, the official, rather sanguine, view is that the scrutiny itself has a disciplinary effect and that, as a result, there exists in EFTA "a pressure on its members fully to observe the letter as well as the spirit of its rules." [4]

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[3]The case involved the building of two highly subsidized aluminum smelters in the United Kingdom, to the clear detriment of both Norway and the U.K. taxpayer. Norway complained that a "benefit conferred by the Convention" — namely, the right to export to the United Kingdom in conditions of fair competition — was being frustrated. The legal niceties of this case need not detain us here. But it was significant that the United Kingdom not only refused to change its behavior but the Council also failed to make any ruling on the matter. It was not a particularly edifying episode, and it certainly highlighted the problems of asymmetrical power relationships in even as easy-going a club as EFTA.

[4]EFTA Secretariat, *The European Free Trade Association*, p. 29.

Be this as it may, it is not at all clear that this informal dispute settlement procedure could or should be transposed to another setting. It works in EFTA for the reasons mentioned above, but peer group monitoring may only work among small groups of countries of roughly equal size, if at all. For instance, it does not work in the GATT, although the basic approach to surveillance and dispute settlement is exactly the same as in EFTA. Furthermore, it certainly could not work in a bilateral context, for there would be no independent third parties to whom to turn for an impartial assessment. And, of course, if the bilateral setting is made up of entities of very different size, the question of equity in dispute settlement procedures becomes acute.

This first phase of EFTA's existence demonstrated that the free trade area concept was a workable proposition. The lightweight institutional framework proved to be adequate, the technical aspects — such as origin rules, discussed below — worked smoothly, and, last but not least, the actual freeing of trade did not prove disruptive.

Freeing Trade within Europe, 1972 to Date

In December 1969, the heads of government of the six EEC countries met at The Hague and decided, among other things, to open negotiations on Community membership with the four countries that had filed applications to join: Denmark, Ireland (which was not an EFTA member), Norway, and the United Kingdom. Vitally, for the nonapplicants, the EEC heads of government also decided to launch discussions with a view to defining "suitable" trading arrangements between the Community and the remaining EFTA countries. Negotiations between the four candidate countries and the Community began in June 1970 and resulted in the signature of the treaties of accession in Brussels on July 22, 1972, with formal membership to take place on January 1, 1973.

For the nonapplicant countries — joined late in 1972 by Norway, whose electorate rejected the treaty of accession by referendum — serious discussions began in the autumn of 1971, in a negotiating climate much helped by the amazingly well-timed "Nixon measures" of August 1971,[5] which galvanized political will among the Six as

[5]It will be recalled that in August 1971, the United States introduced a 10 percent import surcharge to protect its deteriorating balance of payments and to shore up the external value of the U.S. dollar. The move was viewed in Western Europe as *(continued)*

nothing else could possibly have done. A period of intense negotiation followed, culminating in July 1972 with the signature in Brussels of a series of free trade agreements between the European Community on the one hand and each of the remaining EFTA countries on the other.

Although negotiated bilaterally, the free trade agreements are virtually identical. They all follow the same pattern, although the details of certain Protocols relating, for instance, to "sensitive" items, differ from agreement to agreement, depending on the country involved. Finland, for example, was obliged to accept a substantially longer tariff-cutting schedule for paper products, lasting until 1984, while Sweden had to accept similar treatment, *inter alia*, for special alloys; complete free trade for nonsensitive products, on the other hand, was scheduled for 1977 for all of the agreements.

The agreements were mini-Stockholm Conventions. They aimed at creating conditions of free trade for all industrial products with few concessions in agriculture, fisheries, services, or free movement of labor and capital. Their institutional structure was identical to that of EFTA: a single organ, the Joint Council (by definition bilateral), constituted the forum in which the Community and the individual EFTA country would meet to negotiate and act together. The free trade agreements defined a single set of origin rules and established identical rules of competition. The only problem, as far as EFTA was concerned, was the fact that its relationship with the European Community was a bilateral one.

Adjustment to Free Trade in Europe

There is no doubt that EFTA's greatest achievement has been to free trade, not only among its own members but between its members and the European Community. It is also true that this has been accomplished without serious adjustment problems. This experience was paralleled in the EC. In fact, the lack of dire adjustment problems in the course of creating this huge, 18-member free trade system is one of the more encouraging aspects of the process of European economic integration. It is all the more impressive if one

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[5]Continued
being overly hostile to European interests and dispelled any remaining hesitation concerning the wider implications of offering the small EFTA countries preferential free trade access to the EEC's markets.

remembers that these are countries with *competitive* industrial structures — that is, they produce roughly the same range of industrial products, for people at roughly the same level of income and with fairly similar tastes.

One of the interesting conclusions of economic theory is that a union of *competitive* economies is likely to generate greater gains than a union of *complementary* economies. This is because a union of competitors will be painful: there will be blood on the floor, so to speak, but the end result will be the identification, through the competitive process, of the most efficient production locations — hence, specialization and, hence, "trade creation". Specialization — that is, complementarity — is thus the end result of integration, not its starting point. On the contrary, if one starts with the specialization and complementarity already there, all the union can do is to *reduce* competition, leading to "trade diversion". It is the painful process of competition that generates long-term, permanent gains, while the comfortable union of opposites generates long-term, permanent losses.

The (sad) fact to remember is that if freeing trade produces no pain, it probably produces no gains either, since the gains emerge from the compulsory reallocation of resources. In other words, the gains are proportional to the cost of adjustment. However, since the cost of adjustment is a finite, once-and-for-all "investment", while the gains from improved resource allocation represent a continuous flow over time, most economists are confident that a move to a freer and more competitive economic environment will prove beneficial, in the long term.[6] Moreover, there is every reason to believe that the "pain" is much exaggerated.

What the story of European economic integration tells us is that one can have a union of competitive economies with much less "blood on the floor" than is commonly thought. The reason is that a union of advanced industrial economies allows much scope for intra-industry specialization. This has two beneficial consequences. First, whole sectors do not disappear from a country's economic landscape; second, factors of production, especially labor, would find it easier to relocate *within* a given sector than between sectors, thus

[6]Although even noneconomists are fond of quoting Keynes' famous statement that "in the long run we're all dead," they forget that Keynes had no children. Most people, if they think about it, would, I am sure, prefer to bequeath to their descendants a dynamic, competitive economy rather than an anemic weakling.

reducing the cost of adjustment per unit of reallocative gain — improving the cost-benefit ratio of a movement toward freer trade.

Some authors have emphasized the role of economies of scale and product differentiation — both elements of "imperfect" competition — in explaining why intra-industry specialization is so characteristic of European economic integration. I would add that new market "niches" are being discovered every day, and that these are a function of the ever-increasing level of complexity and specialization at the level of the firm, let alone the level of the sector or industry. As Stigler[7] pointed out in the 1950s, as markets grow, firms contract out more and more functions, creating, at each step in the process, new areas of specialization. The same process at work shows up as intra-industry specialization between countries.

Be this as it may, another reason why European economic integration proved to be relatively painless was that the initial phases took place in a generally positive economic climate. Real rates of economic growth were unusually high, unemployment was low, and inflation negligible. Integration was *seen to work*, although most of the credit for this exceptionally good economic scorecard probably needs to go elsewhere. For instance, a massive reallocation of labor from farming to industry and the services sector took place. This, of course, would have occurred with or without economic integration, but it represented an extraordinary jump in the marginal productivity of labor, which, in turn, led to higher real incomes and great labor flexibility, at least for a time.

Yet another important reason, in my view, lies in the extremely tortuous path that European economic integration has taken, starting in the late 1940s with general Europe-wide cooperation within the framework of the OEEC, proceeding with the parallel but separate development of the original EEC and EFTA in the 1960s, and culminating with the merger of the two systems in the 1970s. High politics decreed that the process should be broken up into distinct phases, each step reducing the problem of adjustment to manageable proportions. Looked at from today's perspective, European economic integration has enjoyed a transition period of 30 to 40 years and even now is not fully accomplished.

It is quite impossible to untangle the positive effects of regional economic integration — which was also causing improved resource

[7]G. Stigler, "The Division of Labor is Limited by the Extent of the Market," *Journal of Political Economy* 59 (June 1951): 185–193.

allocation and more intense competition — from a fundamental trend in the same direction deriving from, *inter alia*, technological change, the flight from the land, freer multilateral trade, and monetary stability. Let us just say that they fed on each other in a highly beneficial manner, and economic integration got most of the credit. It piggybacked on the general level of prosperity.

Another factor that probably helped to make economic integration both significant *and* relatively painless in Western Europe in the 1950s and 1960s was a "dynamic" effect: increased competition. It was Tibor Scitovsky's contention,[8] for instance, that European firms did not behave like U.S. textbook prototypes because they operated in small economic environments in which everybody knew everyone else — *les deux-cent familles*.... Thus, rather than compete, they engaged in polite, nonlethal games in which no one was ever supposed to lose. According to Scitovsky, the "average European manufacturer," selling in "a contiguous market with relatively few retail outlets, shies away from encroaching on his competitors' share of the market." Integration, he thought, would "increase the number and geographic coverage of the market outlets...and thus increase the number of firms he regards as his competitors." With "less personal" competition, the producer would be "less considerate" of his competitors' interests and would invest more enterprisingly in more efficient plant and equipment.[9] Such firms, when confronted for the first time in their existence with gloves-off competition, would either perish or discover unsuspected resources of inventiveness and efficiency.

In the event, regional free trade did indeed cause sectors to restructure rather than to disappear outright. Small family businesses gave way to larger firms with more complex ownership patterns. The process of structural adaptation took place within the sector, even within the firm. This then showed up in the trade statistics as intra-industry trade and specialization.

All this was not known when the EC and EFTA were formed. At that time, West Germany was the acknowledged leader in terms of industrial efficiency, and it was initially feared that other members

[8]T. Scitovsky, *Theory and Western European Integration* (Stanford: Stanford University Press, 1958). Something of the same idea resurfaced some years later in Liebenstein's concept of "X-efficiency" (a superb name for it). See H. Liebenstein, "Allocative Efficiency versus X-efficiency," *American Economic Review* 56 (June 1966): 392–415.

[9]Scitovsky, p. 133.

would simply become subcontractors or specialized in food production. However, they soon developed industrial specializations of their own. Ten years later, when it became a matter of integrating the small EFTA economies with the much larger EC market(s),[10] there were few real fears that they might be swamped by larger or more efficient EC producers, presumably because experience with freer trade had proved so positive. In the event, this optimism proved justified, even though the economic climate turned nasty by the mid-1970s.

Two other points need to be made in this connection. First, the original transition periods were lengthy and generous to the point of exaggeration. Both the Treaty of Rome and the Stockholm Convention anticipated the gradual reduction of tariffs in easy 10 percent stages, spread out over 10 to 12 years. In the event, they decided they could do it all much more quickly, and eliminated intra-area tariffs in six to eight years — January 1959 to July 1968 for the EEC, and July 1960 to December 1966 for EFTA. The EFTA-EC free trade agreements took this lesson to heart, and settled for a transitional period of less than five years' duration, with five tariff cuts of 20 percent each, lasting from April 1973 to July 1977. For a few "sensitive" items, as already mentioned, the last tariffs only disappeared in 1984, and even beyond this date, for the "sensitive" products specified — paper, ferro-alloys, specialty steel, zinc, aluminum, chromium, manganese, molybdenum, titanium, tungsten and about 15 other metals — the EC retains the right to re-introduce most-favored-nation tariffs on imports of these goods beyond an agreed "ceiling" quantity. This "sensitive products clause" has not been invoked, although EFTA countries — Sweden and Austria, in particular — have been asked to "respect" the EC's price level for steel and steel products. The general impression is that the tariff-cutting process proved much easier than expected and that the structural problems that did arise were not directly traceable to tariff cuts within Europe but rather to other factors, such as the successive oil price increases or competition from rapidly developing countries. However, just as the economic integration process was

[10]The commissions of the European Economic Community, the European Coal and Steel Community, and Euratom were merged to form a single "Commission of the European Communities", an awkward plural term that one nowadays finds simplified to the singular form "European Community". The abbreviations EEC and EC therefore coexist, and to all intents and purposes mean the same thing.

able to piggyback on general prosperity in the 1960s, it was unable to avoid being affected by the recession of the 1970s.

Thus — and this is the second point — the latter part of the 1970s and the early 1980s were marked by growing state intervention to resist the process of structural change. Subsidies took the place of tariffs. The appearance of integration was saved, but not the substance. Even within the EC, the Commission and European Court of Justice were hesitant to test their powers to set limits to such behavior, while in the context of the EFTA-EC free trade areas, the absence of an arbitration procedure to settle disputes meant that the EFTA countries were quite helpless to stop the progress of subsidization in the EC, however detrimental it was to their trade.

In EFTA itself, Sweden and Austria both helped lame duck industries, but never invoked the relevant escape clause (Article 20). There is some indication that most of these problems are now behind us and that they were directly linked to what one hopes was an exceptional period of structural adjustment following two oil price increases, rapid technological advance, and the simultaneous emergence of several newly industrialized countries. But it is interesting to note that although tailor-made escape clauses existed and could have been used in both EFTA and the EC, they were seldom, if ever, invoked.

At present, EC-watchers are keenly interested in how the Spanish economy will react to free trade with the Community. Both Spain and Portugal have a seven-to-ten-year transitional period for dismantling tariffs on industrial and agricultural products. There are, however, numerous exceptions on both sides for "sensitive" products: in the farm sector and in textiles as far as the EC is concerned, and for automobiles and chemicals as far as Spain is concerned — not to speak of common problem areas, such as steel and shipbuilding, where Spain is expected to apply EC "disciplines", as the Community's implicit cartelization programs are called.

It is interesting to note that both sides are extremely cautious: each fears the other's competitive strengths, and they are all too aware of their respective weaknesses. Spanish industry has developed behind high tariff barriers and is reputed to be inefficient. Yet established producers in northern Europe worry about Spain's cheap labor, its access to large industrial sites, and other advantages, such as its mineral and other resources. In the meantime, French and Italian market gardeners tremble at the prospect of having to com-

pete with the unbeatable Spanish climate, while Spanish one-cow dairy farmers face the awful prospect of having to compete with modern milk factories in France and the Netherlands.

It is easy to see that the potential gains from integration are high for both sides and, indeed, can be measured by the level of mutual anxiety as to the outcome. Will the Spanish accession be traumatic, as everyone seems to expect, confirming the dismal science's verdict of "no gain without pain", or will it prove as smooth and uneventful as was the integration experience of the rest of Europe? Only time will tell, but there is no evidence that any economy has ever been demolished by competition. Sectors may struggle, but consumers will gain, their extra real incomes feeding into the economy and causing it to grow — but with a new structure.

To summarize, the 18-member European free trade system was put in place relatively smoothly, for the following reasons: it comprised a union of competitive economies, permitting intra-industry specialization; it took place during a period of general economic prosperity; it enjoyed a leisurely transition period; and it created a new competitive climate that stimulated structural changes within European firms. The anticipated disruptions, for which ample provision was made in escape clauses contained in all the treaties, never materialized. Yet no one could deny that far-reaching structural changes in fact took place.

2

Technical Features of EFTA and the Free Trade Agreements with the European Community

The success or failure of any free trade area — and EFTA was no exception — turns on how it deals with a large number of technical matters. The creation of satisfactory rules of origin is an essential feature of any association that does not harmonize tariffs against nonmember countries. The removal of tariffs can be an empty show unless effective ways are found for dealing with nontariff barriers in the form of government subsidies, public purchasing practices, restrictive business practices, dumping, and a host of technical barriers to trade. Effective dispute settlement is imperative to ensure that what has been joined together does not later fall apart. Dull, prosaic, and certainly not the stuff of newspaper headlines, nonetheless these matters are the building blocks on the strength of which the whole edifice of free trade depends.

Rules of Origin

When the subject of a European-wide free trade area was first mooted in the Organization for European Economic Cooperation in 1956, one of the principal technical objections voiced by the members of the nascent European Community (EC) was that free trade areas could not actually function. The fact that the members of a free trade area kept their independence with regard to foreign trade policy meant that a system of rules of origin would have to be put in place to prevent deflections of trade. This much was common ground, but whereas the supporters of the U.K. proposal thought that the administration of an origin system was perfectly feasible, the Six of the EC felt that it was open to much abuse, that unscrupulous traders would get around the rules, and that the cost of monitoring would be much too high. In particular, the British pointed out that many years of experience in administering an Imperial preference scheme made them confident that no insuperable

problems would be discovered. The French argued, however, that it was easy to operate an origin system if the parties were geographically separated by plenty of water, but that it would be impossible to check smuggling along a reasonably open — no barbed wire, for example — contiguous frontier.

There was no way of knowing, in 1956, which thesis would prove correct. Perhaps the second of EFTA's achievements was to demonstrate that it was possible to devise an origin system that could be administered — and monitored — adequately.

Rules of origin can be strict or lenient. If the definition of "area of origin" is strict — say, 100 percent of the cost of production must be incurred within the free trade area — then, clearly, very few goods would qualify. The free trade area would be largely meaningless, distortionary, and contrary to Article XXIV of the General Agreement on Tariffs and Trade (GATT). However, if the definition is generous — say, packaging and transport within the area of association is sufficient to give the product "area" status — then tennis shoes made in Taiwan could be imported wholesale into one country and, with little modification, enter the partner country duty free. Economists generally would applaud such an outcome since it would make high tariffs redundant, but "deflections of trade", as they are called, also generate inefficiencies, if only those of unnecessary transportation. In any case, such deflections of trade would make nonsense of the idea of countries being able to retain some measure of tariff-making power within a free trade area. Rules of origin, neither too generous nor too severe, are therefore part and parcel of a free trade area.

Rules of origin, however, can only cope with the first order of distortions arising from the lack of a harmonized external tariff, and steps need to be taken to minimize a number of problems.

For instance, no origin system can stand the strain of great differences in members' tariffs: one should not place temptation in the path of potential smugglers, after all. The European Free Trade Association (EFTA) was lucky in that most of its members were low tariff countries, so "tariff dispersion" among its members was inherently limited to a few percentage points — certainly not enough to cover the cost of transshipment and the transactions cost of cheating. Furthermore, the two high tariff countries — the United Kingdom and Portugal — were geographically separated from the rest and therefore met the "colonial" test of geographic remoteness.

Once more, the rewards to smugglers did not outweigh the costs, despite the higher level of tariff dispersion.

Another problem arising from the existence of disparities in members' tariff structures is the possibility that they may give rise to inefficient investment decisions. Suppose that country A protects its microprocessor industry, while country B does not. While both apply the same duty on, say, computers, this downstream user industry will flourish in B but not in A, not, perhaps, because B has any real comparative advantage in such an activity, but just because it gives the downstream user industries a high level of effective protection — that is, it does not penalize it by making its inputs expensive. Country A, of course, is free to shoot itself in the foot in this way, but I would argue that it is unlikely to do so. This is one of the reasons that suggest that there will be pressures toward a *convergence* of tariff structures within a free trade area that will be hard to resist in practice. The operative question is whether the convergence will be upward or downward, and whether the smaller members will gradually bring their tariffs into line with the larger ones. In Europe, this convergence has occurred quite naturally as a result of successive GATT Rounds: as most tariffs fell to negligible absolute levels in the 1960s and 1970s, the rate of dispersion also diminished. Today, in fact, the difference in tariff rates between EFTA and the EC is 5 percentage points, or less, for over 60 percent of EFTA-EC trade.[1] This raises the question of whether the need for origin rules can wither away *before* full harmonization of tariff structures is reached. If so, it is certainly an avenue worth exploring, as the administration of rules of origin is not entirely costless. In EFTA-EC trade, 25 percent of traffic both ways seems to prefer paying low duties — of up to 2.2 percent — to the bother of complying with the origin criteria.[2]

An additional problem arises from the combination of nonuniform external tariffs and free trade within the area of the association: that of *indirect* trade deflection. While rules of origin are designed to prevent direct trade deflection — the Taiwanese tennis shoe example above — no origin system can prevent indirect deflections in the long term. These occur after producers have had time to make long-run cost adjustments and have achieved an optimum scale of

[1]J. Herin, "Rules of Origin and Differences between Tariff Levels in EFTA and in the EC," Occasional Paper 13 (Geneva: EFTA Secretariat, 1986), Table 3.
[2]Ibid., p. 6.

operation. If we accept for the sake of argument the dictum — popularized by economists at the University of Chicago — that unit costs of production are constant in the long run, and if we add for good measure that a country's domestic price level for traded goods is equal to the world price plus the tariff, then one reaches the conclusion *ceteris paribus*:

(a) that the low tariff partner in a free trade area will set the price level for the whole area — the law of one price applied to the free trade area;
(b) that the high tariff partner's tariff will become redundant over time; and
(c) that the low tariff country will expand production to meet the reduction of production in the high tariff country — this increase in production occurs because there is a stage during which prices in the high tariff country will be higher than in the low tariff country, although in the end prices revert to their original level in the low tariff country; there is no improvement in the terms of trade.

Even if costs in the low tariff country are not constant — or, if one prefers, before the industry reaches its long-run equilibrium — imports from the rest of the world will always be available to make up for any shortfall in that country's market, making it that much easier to meet demand in the high tariff country. It is this "shifting" effect that is called indirect trade deflection.

The long and short of the matter is that the high tariff country will find that it has lowered its tariffs by default — unless, of course, it can persuade its partner to raise its tariffs instead. The former, of course, is not an outcome to be deplored but welcomed, since the high tariff country will benefit from lower prices and increased competition, while producers in the low tariff country will expand production but be given no extra tariff-linked privileges.

The situation of exporters in the high tariff country is slightly different. Even the high tariff country has areas of comparative advantage, and whatever domestic price is practiced, if the high tariff country is exporting to its future partner before union at world market prices, then after union the margin of preference in the low tariff partner country should allow the high tariff country to improve its

terms of trade. However, it should never lose sight of the combined effect of (a) potential distortions of investment due to negative effective protection for otherwise viable industries and (b) the loss of nominal protection through indirect trade deflection. The interaction of these two effects might seriously jeopardize efficient industry, especially if the partners are close geographic neighbors, as would be the case in a Canadian-U.S. free trade area. The remedy, as already stated, is convergence, though not necessarily harmonization, of tariff structures. The evidence, as far as Western Europe is concerned, is that this convergence has in fact taken place (see footnote 1 to this chapter), but the process has been so gradual that it has never become a political issue. It was the result of pursuing economic integration in conjunction with major efforts to free trade in the framework of multilateral GATT Rounds — a process that, as mentioned earlier, spanned four decades.

Although it is convenient to discuss these matters in terms of "the high tariff country" and "the low tariff country", it is clear that these are just averages and that, on a sector-by-sector basis, the roles may be reversed.

What Kind of Origin Rules?

Origin rules are inherently complex. They can be based either on a value-added criterion — the original EFTA Convention chose 50 percent as a nice round number — or on a "sufficient transformation" criterion. Here, "transformation" processes are defined that, if they are conducted within the area of association, confer on the product the quality of being of area origin. It might sound like a Herculean task to define qualifying processes for tens of thousands of products, but the European free trade system benefited greatly from the fact that all countries used the Brussels Tariff Nomenclature (BTN) — a uniform classification system based on the progressive transformation of goods, from original raw materials all the way up to complex, finished products. The EFTA origin system used this property of the BTN classification system to define qualifying processes for any number of goods: if a process was sufficient to move a product from a lower to a higher tariff classification, that was enough to endow it with area status.

In fact, the original EFTA system offered producers the *choice* of these two methods. This was an important liberalizing factor and

one that meant that, in practice, many goods acquired area origin status with considerably less than the 50 percent benchmark of value added within the area.

In the EFTA-EC free trade areas, on the other hand, producers usually have to meet both a value-added criterion and a transformation criterion. The element of choice has disappeared, and the effect has been to make these origin rules much stricter than the old EFTA rules. Because of the practical difficulty of administering two different sets of origin rules, the EFTA countries were obliged to apply the more onerous EC rules to intra-EFTA trade as well. Although the EFTA countries have for years been pressing for a less rigorous definition of origin, the EC (understandably) has turned a deaf ear to these pleas. The EFTA countries having, on the whole, lower tariffs than the EC, the latter might find that some of its efficient industries were jeopardized by the interaction of negative effective protection and indirect trade deflection mentioned above.

In the case of Canada and the United States, the roles are reversed: the smaller of the two happens to be the high tariff country. Canada therefore would probably press for a strict definition of origin in order to reduce the scope for indirect trade deflection. But one can only reemphasize the fact that Canada, in its own best interests, should align its tariffs in a downward direction. Is this a serious loss of independence with regard to external trade relations? In terms of freedom to pursue bad policies, perhaps. But if the aim is to put Canadian industry on a stronger long-term footing, this need to align external tariffs in a downward direction could be used to swap tariff concessions with third countries and open up export markets not only with the United States but also with other trading partners.

Whatever the indirect effects of nonharmonized tariffs and origin systems, however, EFTA managed to demonstrate to everyone's satisfaction that an origin system could indeed be made to work among highly developed countries with open, contiguous borders. This demonstration was perhaps the main factor in determining the choice of integration method when, in 1971–72, the nonapplicant EFTA countries negotiated their links with the EC. As mentioned earlier, the EC was still worried about the implications of a European-wide free trade area, to the point where all it was prepared to offer was a series of bilateral free trade agreements with the EFTA

countries. At one point, even this solution was considered too radical and dangerous, and a partial preference scheme was suggested instead, largely because skepticism as to the practicability of administering rules of origin still existed. Not only would this have been illegal in the eyes of the GATT, but the EFTA countries would not have been fully integrated, in terms of industrial goods' markets, with the EC. They therefore indignantly rejected this proposal, and insisted that their own experience had shown that origin systems could be made to work, and work smoothly. Reluctantly and without conviction, the EC finally agreed to give the free trade area concept a try. Since then, even though one can fault the EC origin system on its severity, one has to admit that it works. There are about 4,700 km of contiguous frontiers over which trade is governed by origin rules in Western Europe, not to speak of a great many more kilometres of noncontiguous but by no means distant frontiers. As far as can be ascertained, no serious operational problems have been encountered.

Nontariff Barriers

Nontariff barriers are a well-known problem that has to be addressed in any scheme involving the reduction or elimination of tariffs or quantitative restrictions.

This section discusses EFTA's approach to nontariff barriers — known as the "competition rules" — because here, too, lie some of its lesser-known achievements. In what follows, we shall see that a pragmatic approach based on what can best be described as an "effects doctrine" allows EFTA to function without the need for harmonization of policies, practices, or regulations.

Government Subsidies

The Stockholm Convention's rules on government subsidies are contained in Article 13. Explicit export subsidies are prohibited, which is natural enough and quite straightforward. Other subsidies, however, are more problematic. Members agree "not to maintain or introduce...any other form of aid, the main purpose or effect of which is to frustrate the benefits expected from the removal or absence of duties and quantitative restrictions on trade between Member States" (Article 13 [ii]). Thus, general production subsidies, for instance, are not prohibited as long as they do not influence intra-

area trade. Only if they "frustrate" a partner in its "expectations" do they become a matter for consideration by the parties involved and later by the group as a whole if the parties find that they cannot resolve the difficulty. This "frustration clause", as it came to be known, is close to the GATT concept of "nullification or impairment" of benefits, and concentrates on the practical *effect* of national support policies to various industries.

The EFTA countries subjected Article 13 to a review in 1968 and agreed that its purpose was to make sure that members did not use their freedom in matters of subsidization to "promote unfair conditions of competition between Member States."[3] They also agreed that government subsidies were "legitimate instruments of economic policy," that it was "not the purpose of Article 13 to inhibit the freedom of Member States to introduce government aid measures as elements in internal economic policies," that "as a free trade area," EFTA accepted "the differences in institutional and economic structures of the Member States," and that "the Convention [stated] *no obligation to harmonize government aids*" [emphasis added]. The EFTA philosophy with regard to government subsidies therefore reads very like the classical definition of liberty: your freedom ends where mine begins.

Given this basic rule, it is clear that one can quite easily establish a list of criteria that, if followed, would give subsidies a high probability of being normally consistent with the free trade area obligations. For instance, the more general subsidies are, the less distorting they are likely to be; also, low levels of support are unlikely to produce effects large enough to "frustrate" one's partners' expectations; and, finally, subsidies to activities not covered by the free trade area, or in which one's partners have no trade interest, are unlikely to cause "frustration".

Regional policies are on the borderline. The EFTA countries agreed that they were allowable "to the extent that they do not interfere with conditions of fair competition in EFTA trade" and, to this end, they should be designed "to put industries in regional development areas on an equal economic footing with industries in other parts of the country," but should not give them any advantage. This is clearly a difficult criterion to apply in practice, because it suggests that regional aids should be tailored to every specific case, in order

[3]European Free Trade Association, Secretariat, *The European Free Trade Association* (Geneva 1980), p. 53.

to ensure that an industry that might have established itself in a development area anyway does not enjoy a regional subsidy. To paraphrase Sir Walter Scott, we know not the tangled web we weave when first we practice to deceive...market forces. In short, the criterion for the acceptability of regional subsidies agreed on by EFTA is certainly not a model to be followed. It looks good on paper but would be a nightmare to apply in practice. The EC, incidentally, has not done much better: it allows members to designate development areas that are then classified according to their degree of need. Projects in "highly assisted areas" can be given subsidies of up to 75 percent of their costs, whereas mere "assisted areas" can expect to get only 40 percent of their costs covered, not to speak of "intermediate areas", which are good only for 30 percent, and "general" areas, which, at 25 percent support levels, look quite uninteresting. One can only wish policymakers good luck in their attempts to combine regional policies with free trade! It is inherently conflict laden. Instead of attempting to whitewash regional policies in a free trade area, they would be wiser to apply the pragmatic effects doctrine: I can live with your regional policies as long as they do not jeopardize my own interests. Why should *I* pay for *your* problems?

In the event, the EFTA countries found that the subsidy issue was sufficiently distorting, potentially, to merit a formal notification procedure whereby members agreed not only to notify each other about existing aid schemes but also about planned measures, so that other members could voice their objections, if possible, before problems arose. These procedural aspects of putting the effects doctrine into practice are clearly important, but one should also be clear as to what is implied: the right of the EFTA partners to participate in the formative stage of domestic policymaking.

Public Purchasing Practices

It is well known that public agencies can use their not insignificant purchasing power either as a conscious instrument of industrial policy or merely as a means of subconscious, instinctive protection. Since the amounts involved are large and the scope for intentional or accidental discrimination is wide, free trade areas are obliged to address the issue. EFTA is no exception. Article 14 of the Stockholm Convention lays down that members "shall ensure the progressive elimination, ...in the practices of public undertak-

ings, of...trade discrimination on grounds of nationality in so far as it frustrates the benefits...."

We can note, once again, that although members agree on the *elimination* — a very strong term — of discrimination on the part of public purchasing entities, this only applies to the extent that other members have a trade interest in the actual case, otherwise they would not be able to complain that their expected benefits are being frustrated. Again, this is the EFTA effects doctrine, which one finds expressed time and again in relation to nontariff barriers.

In order to ensure the proper application of Article 14, the EFTA countries agreed to a series of tendering procedures, including the adequate publicizing of public tenders in other EFTA countries, allowing for sufficient time for EFTA suppliers to compete for contracts and promising not to impose conditions on the purchase of goods that might act as an indirect obstacle to tender by firms in other EFTA countries. The EFTA Secretariat even went so far as to publish a booklet containing a list of all the major public procurement agencies in the EFTA area.[4]

Unfortunately, there have been no studies of the practical implementation of Article 14 within EFTA itself, but it is common knowledge that public procurement remains one of the EC's more embarrassing gaps and that no progress at all has been made on this issue in the context of EFTA-EC trade. At the April 1984 Luxembourg ministerial meeting between EFTA and the EC, it was agreed that they should improve the free circulation of industrial products by, *inter alia*, opening access to government procurement on a reciprocity basis. However, this appears to be a dead letter for the time being, perhaps because the EC cannot in practice extend to EFTA what it has failed so far to achieve for its own members.

One foreseeable problem, however, is that opening up access to each other's public markets on a reciprocity basis is all very well if countries are of roughly equal size, but what if one unit has a public procurement "market" of some hundreds of millions while the other has one of some hundreds of billions? It looks like a very unequal bargain, very much in favor of the smaller partner. The answer, of course, is that the whole purpose of the exercise is to ensure, through competition, that both entities gain from lower prices, irrespective of which firm, in which country, gets the order. Competi-

[4]European Free Trade Association, Secretariat, *Public Procurement in EFTA* (Geneva, 1971).

tion and lower prices are the essence of the gain from freer (regional) trade — not the Rambo-esque "capturing" of markets. Indeed, the fact that new market opportunities are opened up by this or that measure is no guarantee that they will be seized — unless the firms concerned are competitive, in which case both parties gain, as stated above. In state-to-state negotiations, however, one tends to lose sight of the real underlying purpose of attempts to free trade, and to swap "market opportunities" of roughly equal size instead. As long as this mercantilistic mentality prevails, small countries will find it very difficult indeed to swap public procurement markets with large ones, especially in an asymmetrical bilateral relationship such as the EFTA-EC or Canadian-U.S. nexus.

Another government procurement issue arises when countries are organized on federal principles. Since EFTA contains one very decentralized state — Switzerland — it has to address the question of which levels of government are bound to follow its rules with respect to public procurement. It was agreed at a very early date, in October 1966, that Article 14 applied to "central, regional or local government authorities, public enterprises and any other organization by means of which a Member State, by law or in practice, controls or appreciably influences imports from, or exports to, the territory of a Member State." After this brave formulation, however, it was acknowledged that where member states did not have "the necessary legal powers to control the activities of regional or local government authorities or enterprises under their control," they should "nevertheless endeavour to ensure that those authorities or enterprises comply with the provisions of this Article." Thus, member states were *required* "to make use of any legal powers at their disposal to control or influence the procurement activities of regional or local authorities."[5]

This is an issue that will also have to be resolved in a Canadian-U.S. free trade arrangement but here, at least, both parties possess federal structures. If it is any consolation, the West German *Lander* are growing increasingly restive and often object to having to apply EC regulations, so even the tightly knit EC has to cope with the problem of federal subunits wishing to go their own way. I am taking no bets, however, as to which side generally wins in the end.

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[5]EFTA Secretariat, *The European Free Trade Association*, pp. 56–58.

Restrictive Business Practices

How does one handle *private* barriers to free trade? Both European integration schemes address the issue, as it was feared that firms might erect their own barriers to trade once the governmental ones had disappeared. EFTA's Article 15 follows the conventional distinction between cartels — "agreements between enterprises, decisions by associations of enterprises and concerted practices between enterprises" — and actions by a single dominant firm acting alone — "actions by which one or more enterprises take unfair advantage of a dominant position." Article 15 then goes on to stipulate that these restrictive practices are incompatible with the Convention "in so far as they frustrate the benefits expected," so one is back with EFTA's by now familiar effects doctrine.

A second point to note is that one is discussing not the actions of states but those of private persons. Usually, international rights and obligations do not apply *directly* to individuals, nor can they be invoked in a domestic court of law — although the extent to which this is so varies from country to country. So how did the EFTA countries propose to apply Article 15 in practice?

The answer, quite simply, is that antitrust matters had to be settled through conventional diplomatic channels and that, therefore, members had to rely on each other's good faith in prosecuting illicit practices. Indeed, according to the EFTA Secretariat's semi-official commentary on this provision, "it would be a breach of good faith for Member States to allow, within their jurisdiction, these practices to frustrate the benefits expected under the free trade arrangements. If this was the case, then the States should bring the practices to an end.[6] Was this a pious hope or a meaningful proposition?

To answer this, one has to look at the trigger mechanisms. These are weak. The EFTA Council itself is powerless to launch investigations, although once complaints have been brought to its attention, it can publish a report on the case, the idea being that this alone will bring pressure on firms to alter their behavior. (Needless to say, this has never happened and is definitely in the realm of pious hopes.) There is, in fact, only one possible trigger mechanism: "any firm which feels that its activities are hampered by practices of this na-

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[6]Ibid., pp. 59–62.

ture taking place in another Member State may refer the case to the competent authorities in its own country."[7]

In other words, national jurisdictions remain national jurisdictions. The "competent authorities" in the victim's country then bring the case to the attention of the "competent authorities" in the partner country, who are obliged "to examine with care complaints about restrictive business practices infringing Article 15 on the part of firms in their own territory." At this stage, the procedure is informal, bilateral, and confidential. It is also interesting that in this field of potential jurisdictional conflict, EFTA countries should have attempted once again to introduce a pragmatic note. They agreed that they were prepared to investigate cases "wherever there is some *prima facie* evidence of infringement of Article 15 and they will not make such an investigation dependent upon the submission of a formal complaint or a fully documented case."[8]

If the informal, bilateral, and confidential diplomatic negotiations lead to an agreement that an infringement of Article 15 is in fact taking place, the members "will use administrative means to influence the parties and if this is unsuccessful will, in appropriate cases, consider using such legal powers of enforcement as are available to it." One can almost see the negotiators tiptoeing over this diplomatic minefield: let us first try "administrative" means to "influence" firms; then, if (as we might expect) this is unsuccessful, we might (but only in appropriate cases) "consider" using "such" legal powers as we have (which are not great).

The fact of the matter is that EFTA countries do not have antitrust legislation as it is understood in the United States or in West Germany — whose own strict legislation was imposed on it after the war by the United States. Cartels in EFTA countries are generally not prohibited, just registered and monitored. In fact, they are often considered to be a sensible stabilizing factor in domestic markets. In many ways, Scitovsky's view of the European businessman still applies to the tiny, "cousin" economies of EFTA countries. They are saved from the dire consequences of such a cosy environment only by the fact that imports, rather than an antitrust authority, exercise the function of enforcing competition.

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[7]European Free Trade Association, "Public statement on EFTA policy in the field of restrictive business practices" (Ministerial meeting, Copenhagen, October 1965).
[8]Ibid.

This having been said, the reader will not be surprised to hear that in EFTA's 28 years of existence, a grand total of four cases have been reported to the Council *ex post facto*, all of which were resolved bilaterally to everyone's satisfaction long before anyone could reach any conclusion as to whether the practices complained of were or were not contrary to Article 15. This contrasts sharply with the thousands of antitrust cases brought every year to the attention of the EC authorities.

The two approaches could not be more different. While EFTA limits trigger mechanisms to a bare minimum and treats the subject entirely as a matter for state-to-state negotiation and compromise, the EC has developed a fully fledged supranational judicial control over antitrust questions.

In the bilateral EFTA-EC relationship, the actual treaty provisions are even slimmer than those in the original Stockholm Convention, but the basic approach remains the same: Article 23 of the EFTA-EC agreements states that agreements between firms "which have as their object or effect the prevention, restriction or distortion of competition as regards the production of or trade in goods [are considered to be] incompatible with the proper functioning" of the agreements. Similarly, "abuse by one or more undertakings of a dominant position in the territories of the Contracting Parties as a whole or in a substantial part thereof [is also] incompatible with the proper functioning" of the agreements.

We note the disappearance of the effects doctrine: the "frustration" criterion has gone, and has been replaced by a blanket "incompatibility" criterion — to be ruled on, in the first and last resort, by the Joint Committee, after which one presumes (but this is nowhere stated explicitly) that each member would then apply its own antitrust rules to the case in point.

A major case in this regard is the Hoffmann-LaRoche loyalty discounts case, where an informer supplied the Brussels antitrust authorities with documents concerning the Swiss firm's sales policies with regard to certain vitamins. The EC Commission was able to demonstrate that Hoffmann-LaRoche treated some of its customers more favorably than others, depending on the extent to which they agreed to obtain their supplies from the company.[9] The Com-

[9]See, for example, European Community, Commission, *Ninth Report on Competition Policy* (Brussels; Luxembourg, April 1980), pp. 27–30.

mission argued that this constituted an abuse of a dominant position, because the company was using its monopoly power in one group of vitamins to exclude potential competitors in another group of vitamins. The European Court later confirmed most of the facts of the case, upheld the Commission's argument that the case constituted an abuse of a dominant position according to the EC's own antitrust law, and fined Hoffmann-LaRoche 200,000 European units of account.

What is interesting about this case, for our present purposes, is that at no time did anyone raise the question of whether Article 23 of the Swiss-EC free trade agreement applied. From the outset, the EC decided to treat the case as though it were a normal Community antitrust case, involving a Community firm. We are not told whether Switzerland objected to this. But the fact of the matter is that the EC antitrust arm, like that of the United States, stretches beyond its own territory on the grounds of the ever-useful effects doctrine: namely, if firms on foreign soil engage in anticompetitive activities that exercise an "effect" in the EC, they fall within the scope of the EC's antitrust laws. The EC cannot, of course, conduct investigations outside its territory, or *enforce* judgments (such as the payment of fines), but it can sequester any assets owned by the foreign firm in its territory. If the firm is interested in doing business in future in the Common Market, it has every interest in complying with the law, just as though it were a Common Market "citizen".

This case seems to show that the antitrust provisions of the free trade agreements are quite inoperative and that EC antitrust policy applies in practice to EFTA firms in their business relationships with the Common Market. Conversely, should an EFTA country ever wish to complain about a restrictive practice engaged in by a Community firm in its own market, it could go through the diplomatic channels described above — in which case the EC antitrust authorities would use their powers in good faith to halt the practice if they agreed that it was contrary to the free trade agreement — or the EFTA country might use its own antitrust law, as the EC has done. This second approach, however, would strike little fear in the heart of any self-respecting cartel or dominant firm, and so we must conclude that the EFTA countries are free riders, willing or not, on the EC's antitrust policies.

A Canadian-U.S. free trade system likely would cope with private actions in restraint of competition in a similar manner. U.S. antitrust legislation probably would gradually become the operative law for the Canadian-U.S. economic "space" — unless Canada took active steps to prevent it from doing so.

Dumped and Subsidized Imports

In addition to the rules on government subsidies discussed above, the Stockholm Convention contains an intriguing provision known as the "boomerang clause". It stipulates, in Article 17, that member states are obliged to accept the return, free of duties, charges, or quotas of any kind, of any goods that have previously been exported from their territory and that have not undergone any transformation. The purpose of this clause is to provide for "reverse dumping", as an additional guarantee against the proliferation of distorting subsidies or (as the case might be) private predatory pricing. A similar rule appears in Article 91(ii) of the Treaty of Rome, but applies only to dumped products — that is, sales by private firms at prices lower than those practiced in the ordinary course of trade in the exporting country — whereas EFTA's boomerang clause applies to both dumped and subsidized exports.

Such a provision sets a self-governing limit to discriminatory pricing within the free trade zone. Although it has been little used, it presumably acts as a useful deterrent against the more blatant forms of price discrimination, especially hidden forms of export subsidization. However, it is of no avail against *general* subsidies (discussed in Chapter 1), which reduce prices both at home and abroad and distort competition without price discrimination.

In addition to the boomerang clause, EFTA contains a further deterrent against dumping and subsidization within the free trade area in the form of a conventional right for any member to "take action" against dumped or subsidized imports "consistent with its other international obligations" — namely, the GATT. Unlike in the EC, where individual member states may no longer take antidumping actions against other members, as described above, EFTA countries retain this right, although they have never used it. We return to this question below in the section on dispute settlement under the bilateral free trade agreements.

Technical Barriers to Trade

The Stockholm Convention, like the GATT and even the Treaty of Rome, provides for a series of exceptions to the general free, or freer, trade rule based on such considerations as the protection of public morals, the prevention of disorder or crime, and so forth. What interests us here is that member states can adopt and enforce measures "necessary to protect human, animal or plant life or health" (Article 12). The Treaty of Rome goes even further, allowing "prohibitions or restrictions on imports" on grounds of "public morality, public policy or public security; the protection of health and life of humans, animals or plants" (Article 36).

These traditional exceptions, found in all international trade treaties, in reality open the floodgates of nontariff barrier protection. Since each member state has its own view of what constitutes human, animal, or plant safety, it can use its regulations to thwart the general free, or freer, trade purpose of the treaty.

One way of coping with the problem is to try to harmonize members' technical and safety regulations. Thus, the Treaty of Rome, in Article 100, provides for "the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the common market." In other words, it assumes that *some* harmonization of legislation is necessary for the smooth functioning of the EC.

EFTA, as we mentioned earlier, was established to prove almost the contrary. The Stockholm Convention certainly makes no equivalent provision for the harmonization of laws, regulations, or administrative actions. In the particular area of national technical norms and specifications, however, EFTA countries have found that excessive diversity is indeed potentially destructive.

In fact, technical barriers to trade (TBTs) have emerged in Western Europe as the most divisive and hardy of all remaining nontariff barriers, and are largely responsible for preventing the 18-member free trade area from becoming a single market in practice. As a result, European industrialists cannot enjoy the economies of scale that the existence of a single tariff-free market of 360 million people theoretically provides.

Within the EC, the problem of TBTs was tackled head-on with the elaboration of "Euro-norms". However, this approach has recently been abandoned because it has become increasingly impossible

to apply: each norm had a gestation period lasting several years; because unanimity was needed for their adoption, only a few Euronorms a year could be agreed on; they were of incredible detail and complexity; and they tended to be out of date by the time they were published. In the meantime, industrial development rushed ahead, bringing forth a constant flow of new national norms and specifications, all different from each other. In short, the problem of TBTs got worse, not better, despite the immense amount of effort that went into harmonization as provided for under Article 100 of the Treaty of Rome.

In EFTA, not only were member states philosophically opposed to harmonization, it also would have made no sense, in a setting as limited as EFTA, to attempt to develop "EFTA-norms". Accordingly, EFTA's approach to the problem was quite different from the EC's but, in its modest way, has proved quite successful, although it certainly did no more than cope with two small aspects of the problem.

In 1964, EFTA agreed on a system of advance notification of all new or amended technical regulations. Its purpose was to provide for consultation in cases where new technical regulations might give rise to extra trade barriers. The main innovation here was that new regulations were discussed among EFTA members *before* they were enacted. In practice, governments tended to model their regulations on those worked out by private, nongovernmental bodies such as the International Standardization Organization, so that there was a good chance that most new technical specifications were effectively standardized, to some degree, on a voluntary basis. In 1984, 20 years after EFTA's scheme, the EC introduced legislation that obliged its members to exchange information on draft technical regulations, in order to diminish the risk of creating new divisions in the future.

Another EFTA "innovation" in this area concerned the mutual recognition of tests and inspections. Traders frequently complain that even if a product is manufactured to the required specifications in an export market, it can be a lengthy and tiresome matter to obtain type approval. In some cases, it is even suspected that the difficulties and delays are not always entirely innocent, and that they constitute a formidable nontariff barrier in their own right. While EFTA countries did not attempt to harmonize technical standards *per se*, they did develop a series of conventions whereby they agreed to recognize conformity tests carried out by their partners' testing

laboratories according to their own specifications.

For instance, vessels designed to contain fluids under pressure have to meet widely varying safety regulations and specifications, depending on the country. In EFTA, these regulations were not harmonized, but a testing station in, say, Sweden could issue a conformity certificate for a Swedish pressure vessel designed to meet Swiss specifications, which the Swiss authorities would recognize when the product was imported into Switzerland. The Swedish manufacturer did not have to seek prior type approval in Switzerland and could deal with the testing agency with which it was familiar. This was perhaps a modest step, but one of great practical value, as it considerably reduced the transactions cost aspect of certification procedures. A further indication of its usefulness is that the EC is currently contemplating introducing much the same procedure.

Furthermore, since 1985, the EC has abandoned its own labor-intensive harmonization program for all but a set of core standards and, instead, has decided, like EFTA, to work through specialized, nongovernmental bodies. This is an exceedingly hopeful development, since it puts much of the detailed work of developing international standards back into the hands of the private sector while much enlarging the scope for voluntary standardization and much diminishing the risk of a perpetual proliferation of diverse national standards. Industrialists can now consult a central computerized data base covering information on all national standards in operation in EFTA and the EC countries, including comparative information on where and how they may differ.

In addition to virtually abandoning the top-down legislative approach to harmonization and relying more on voluntary, private standardization bodies, especially for all new standards, the EC has also developed a quite revolutionary scheme whereby existing national regulatory systems will be forced into competition with each other. The principle for such an approach has emerged slowly from the workings of the EC's legal system.

In the mid-1970s, an exporter of French liqueurs found that one product — a fruit-based cordial known as *Cassis de Dijon* — was being prohibited entry into West Germany on the grounds that it did not meet West German specifications, which stipulated that liqueurs had to contain more than 25 percent alcohol. *Cassis de Dijon*, however, contained only 15–20 percent alcohol. The case was brought before the European Court, where the West German defense

invoked the right to restrict imports on the grounds of Article 36 (human health), arguing that a wide difference, in terms of alcoholic content, between wines and liqueurs had to be maintained to protect the consumer, who otherwise might not notice the difference. In 1979, however, the Court ruled that if a product had been lawfully produced and marketed in one member state, another member state could not block its importation on grounds of different national regulation unless an overriding public interest was at stake. Furthermore, even if such an overriding public interest could be shown to exist, the measure restricting importation had to be proportional to the risk. In other words, complete prohibition of imports of *Cassis de Dijon* was unjustified and the purpose of the West German law could be met by a mere labeling requirement, warning customers that this was not a standard liqueur.

The significance of this ruling is that the importing country now must justify its actions, while for a whole range of goods the Gordian knot of variegated regulation has been quite simply cut: different standards just coexist. In due course, the market will converge on a set of standards that are the most efficient from the point of view of society as a whole; the harmonization process will have been organic and market driven, rather than conscious and bureaucratic.

The *Cassis de Dijon* ruling, however, is not robust enough to sweep away all problems associated with technical and safety regulations. Safety requirements continue to matter where serious risks are involved, and it is in this area that the EC has adopted a new approach. First suggested in an EC Commission White Paper and subsequently adopted as policy by the European Council, the starting position is that members should agree that "the objectives of national legislation, such as the protection of human health and life and of the environment, *are more often than not identical*" [emphasis added]. The second step is that members should recognize that while the ends are the same, the means of attaining them may be many and diverse. The third step is to grant these different methods mutual recognition in view of "the essential equivalence of the objectives of national legislation."[10]

The new strategy thus plans to take the philosophy behind the *Cassis de Dijon* ruling and extend its application to all standards

[10]European Community, Commission, *Completing the Internal Market: White Paper from the Commission to the European Council* (Brussels: June 1985), pp. 17–23.

except a few, where it will still be "essential to harmonize."[11] The Commission accordingly is working on drawing up a set of "essential health and safety requirements" that will constitute a minimum acceptable level of safety throughout the EC and that, if met, will entitle a product to free movement. The aim is not to produce the detailed standards themselves, but to set the broad criteria that are to be met. The work of actually selecting the standards will, as mentioned earlier, either be delegated to designated nongovernmental industrial standards institutes or be left to the market to select from the menu of existing national standards.

We have discussed these regulatory matters in some detail because it is quite clear that they constitute the essence of freeing trade in the modern age. Tariffs are no longer the primary instrument of protection among developed countries. The implicit protection that remains embedded in tradition, regulation, and a vast "installed base" is large by comparison. Not all of it is intentional — quite the contrary. Industrialists, frequently accused in the past of hiding behind national standards and of sabotaging attempts to produce harmonized standards, are today in the front line of those supporting the EC's new approach, which suggests that they have come to realize that they are among the first to suffer from the fragmentation caused by different national standards.

After several false starts, based on the erroneous idea that the harmonization of standards was possible if enough time and expert technical advice were devoted to it, Europe has embarked on a radical new approach to the problem. It is a market-based, truly federalist approach that combines unity of purpose with diversity of means. The approach undoubtedly is the only one possible in an economic space as diverse as Europe's. Whether the 18 countries that make up the region can generate the spirit of mutual tolerance and respect to make it work is another matter.

The main question is whether this process of regulatory harmonization jeopardizes member states' national sovereignty. The answer, as usual, is that it depends. In the nineteenth century, Spain consciously set a different railway gauge from its neighbor to the north in order to ensure that it could never be invaded by train. Today, Swiss household appliances are made to a standard 55 cm width, while the rest of Europe lives in slightly larger kitchens with appli-

[11] Ibid., p. 19.

ances 60 cm wide. It is a very effective barrier to trade, but hardly a matter of life and death. The really awkward cases occur when standards are used *consciously* to preserve a market from foreign competition. The classic case in Western Europe is the French color television standard, which is incompatible with the more common U.S.-based PAL system and which clearly was chosen in order to ensure a large, protected home market for French TV manufacturers. The result has been many years of very expensive color televisions in France. But does the prospect of a new world standard for high-definition TV threaten French sovereignty. Surely there is not much national sovereignty embodied in the shape of an electric plug or in the number of lines that a cathode ray tube can carry. The issue is either the cost of replacing the installed base — redesigning all Swiss kitchens — or good old-fashioned protectionism — stripping French TV makers of their long-standing protective blanket. To dress it up as an issue of sovereignty is a familiar ploy, dear to the hearts of protectionist lobbies.

EFTA-EC Dispute Settlement Procedures

In the context of the EFTA-EC bilateral free trade agreements, dispute settlement procedures are laid down in some detail, but nothing can alter the fact that they are extremely asymmetrical. In the free trade area that exists, for instance, between Switzerland and the European Community, compare Switzerland's population of 6 million with the EC's population of 320 million. Furthermore, while Switzerland depends on the EC market for more than 50 percent of its exports, the Swiss take just 3.5 percent of the EC's exports.

The free trade agreement between Switzerland and the EC provides for a Joint Committee that is responsible for the administration of the agreement. The Committee "shall ensure its proper implementation,...make recommendations...[and]...take decisions...[that]...shall be put into effect by the Contracting Parties."[12] This all sounds perfectly normal until one remembers that this is a bilateral agreement and that the structure just described applies *inter alia* to dispute settlement; then it makes rather surrealistic reading.

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[12]Article 27 of the agreement. Although negotiated bilaterally, most of the articles in the agreements with the EC are identical, although the numbering may differ.

Actual dispute settlement procedures involve the following steps:

1. As a trigger mechanism, it is stipulated that either Contracting Party may refer a matter to the Joint Committee "if it considers that a given practice is incompatible with the proper functioning of the Agreement."
2. The Contracting Parties must then "provide the Joint Committee with all relevant information and shall give it the assistance it requires in order to examine the case and, where appropriate, to eliminate the practice objected to."
3. Finally, if the Contracting Party "fails to put an end to the practice objected to within the period fixed by the Joint Committee, or in the absence of agreement in the Joint Committee within three months of the matter being referred to it, the Contracting Party concerned *may adopt any safeguard measures it considers necessary to deal with the serious difficulties resulting from the practices in question*" [emphasis added].

Let us now put names to the anonymous contracting parties. Take step 2: Sweden complains about, say, the United Kingdom or France subsidizing the production of specialty steel, which clearly harms its exports, to the Joint Committee — in other words, to the European Community. The EC examines the case and, where appropriate, eliminates the practice objected to. But who decides what is "appropriate"? The EC judges its own case.

Or take step 3: suppose that the Joint Committee has agreed that the practice should be stopped, and has fixed a time limit. Is it not natural to expect that the offending practice will in fact be stopped, since the accuser and the accused have reached agreement in the Joint Committee? If the accused party were to refuse to act, then it would have been negotiating in extremely bad faith! In the specific case of the EFTA-EC free trade agreements, it is of course possible that the EC might agree to something that the United Kingdom might refuse to abide by. If we consider the problem of devising bilateral dispute settlement procedures in a Canadian-U.S. setting, however, it becomes apparent that conventional international procedures can do nothing to alter the reality of the fact that the two parties must negotiate until they reach agreement, in good faith, or risk seeing their arrangement collapse — the permission to take retaliatory action is conventional, but ominous, in view of the two countries' vastly differing abilities to inflict harm on each other.

The only alternative to this unsatisfactory bilateralism would be for both parties to agree to accept the findings of an independent semijudicial panel of inquiry — something which, outside the EC, is unknown in international dispute settlement systems. In the GATT, for instance, parties to a dispute sometimes agree to the establishment of a panel of outside "experts" to conduct an inquiry, but they never agree in advance to be bound by the results. On the contrary, they usually find a negotiated solution long before the panel gets around to making any recommendations.

In EFTA, the reports of specially constituted "Examining Committees" generally form the basis of settlements, *when* the disputes are actually resolved — which is not always the case. But at least there are enough other members to make some kind of independent inquiry possible. In a bilateral setting, there is no other party to turn to. Here, perhaps, is an opportunity for innovation: Canada and the United States could establish a standing committee of "wise persons" whose job would be to make independent inquiries and nonbinding recommendations for the consideration of the "Joint Council" (or whatever it will be called).

Notwithstanding these problems, it must be admitted that the application of the dispute settlement procedures contained in the bilateral EFTA-EC agreements has not given rise to any serious disputes. Problems arise and are dealt with through a process of negotiation until an acceptable solution is found. One learns to live with the situation.

It is also true, however, that, until recently, Western Europe has not been plagued with large numbers of privately initiated contingent protection measures. As far as outside dumping into the EC is concerned, if the case is important enough, the Commission negotiates a voluntary export restraint agreement, or secures a minimum price commitment on the part of the exporting country. As far as dumping and subsidization *within* the EC is concerned, although subsidization is endemic and no one could find a "level playing field" of any size even if they tried, antidumping and countervailing duties have not been permitted since the end of the transitional period. Instead, they have been replaced by the EC's competition laws, which include provisions for acting against government subsidization as well as private anticompetitive actions.

During the 1970s, the EC Commission proceeded prudently when it came to suing member states for subsidizing their declining sec-

tors, but as time wore on and as subsidization threatened to get out of hand, it began to take a much stronger line, to the point where firms were forced to return large handouts and governments were obliged to reconsider whole aid-giving programs.

Since 1980, furthermore, as a result of the Tokyo Round Agreement on Subsidies and Countervailing Duties, the EC has instituted a U.S.-type system of allowing private EC residents (physical or corporate) to petition the Commission directly for antidumping and countervailing duty action with respect to trade between the EC and the rest of the world. About 100 cases a year are brought to its attention under this mechanism. The procedure is administrative, but decisions can be appealed to the European Court of Justice, which brings it within the ambit of the nascent federal judicial system that is now being set in place.

It is interesting that the EFTA countries now find themselves *outside* the EC with regard to these antidumping and countervailing duty actions — and they sense the potential for trouble. Instead of having to use diplomatic channels, which filter their complaints about this or that measure, EC firms now have direct access to the sheriff, so to speak. The outcome is no longer "negotiable" in the sense that the parties negotiate until a compromise satisfactory to both sides is reached; instead, it is placed in the uncompromising hands of the Law. Although in only one or two cases have EFTA countries been the object of antidumping or countervailing duty actions by the EC, they are actively considering the implications of asking the EC to replace the application of its new antidumping-countervailing duty mechanism in trade between the EC and EFTA by the application of its antitrust-competition rules.

It is not immediately clear what the practical benefit of such a change might be, except that antidumping-countervailing duty actions are fairly expeditious (less than a year), while antitrust-competition cases tend to be much more drawn out. On the other hand, the antidumping-countervailing duty actions have to demonstrate "material injury", while matters brought under competition law would only have to demonstrate distortion of trading conditions. Both can potentially end up with the European Court of Justice, whose judges must be presumed to be impartial interpreters of the law. The various pros and cons would require an extensive examination in their own right, but it would be surprising if the EC were to agree to submit its (or its members') subsidy programs to judi-

cial review by, say, the Austrian competition authorities! It is already quite amazing that France, Italy, or the United Kingdom should submit to Brussels in this regard. It is hard to avoid the conclusion that subsidization and free trade do not mix and that one has to choose between the two.

To summarize, disputes in an integrated area tend to arise from the emergence of nontariff barriers. Within the EC, these are dealt with by a nascent federal judicial system, whereby the European Court passes judgment on subsidies, private restrictive practices, and the use of technical regulations to restrain trade, and, in connection with which, private parties have the right to initiate legal actions (through the EC Commission). Between the EC and EFTA, on the other hand, all these areas of potential disputes are dealt with diplomatically; private persons have no direct access to the law. Recently, however, the EC has allowed private persons to initiate antidumping and countervailing duty actions against non-EC imports. This is a significant new development and one that could upset the relatively serene relationship between EFTA and the EC.

3

Lessons for Canadian-U.S. Trade Liberalization

The story of European economic integration is complex, and this paper has addressed only one aspect: the contribution of the European Free Trade Association (EFTA) and the bilateral free trade agreements between the EFTA countries and the European Community (EC). Let us take one step backwards for a moment and view the process as a whole. It has taken over 30 years to get the 18 countries of Western Europe where they are now, and the process of integration is still far from complete. They have a long, shared history of bitter conflict, destructive wars, nationalism, and enmity. Different languages and cultures divide the continent. The years since 1945 represent one of the longest periods of uninterrupted peace that Europe has ever known.

Canada and the United States, whatever the problems that divide them, start from quite a different perspective. In many ways they are already integrated, so integrated in fact that the preservation of a distinct cultural identity appears to be a problem for Canada, the smaller of the two. The key question for Europe was, and still is, how to overcome diversity in order to reap the benefits of economic cooperation. The key question for Canada and the United States, on the other hand, is how to reap the benefits of economic integration while preserving diversity. The free trade area technique is well suited to this purpose.

Let us briefly review the European experience in this regard.

Within the family of Europe, one finds a group of small, neutral countries that wish to remain on good terms with all countries, East and West, North and South, developed, developing, and underdeveloped; they would never wish to apply economic sanctions, for instance, against this or that country as part of a collective decision by a group of countries. Part of the price they pay for this ability to act independently is not to belong to the EC, which, by its very nature, requires collective action on the part of its members.

The free trade area technique, therefore, is well suited to managing the links between the neutral countries of Europe and their neighbors in the EC. Were the latter, for instance, to decide to apply collective antidumping duties or emergency measures against Japanese goods, the EFTA countries would not be obliged to follow suit, and the rules of origin governing the flow of trade between them would be quite capable of picking up the Japanese content in traded goods, thus ensuring that the EC's external trade policy would not be undermined by its free trade arrangements. Both parties' interests are preserved by such an agreement. This degree of autonomy in external trade policy presumably would be valuable for both parties in any Canadian-U.S. trade pact, since it would guarantee (a) that Canada would not be drawn into U.S. trade conflicts, embargoes, sanctions, and so on, whatever their origin, and (b) that U.S. trade measures would not be undermined by an autonomous Canadian policy.[1]

The EFTA countries have also retained an extra degree of autonomy by limiting the scope of their free trade arrangements to trade in industrial goods only. Agriculture, a sector rife with state intervention, is excluded; heavily regulated services such as banking, transport, and insurance are not included; industrial policies only fall within the scope of the free trade arrangements insofar as they exercise tangible negative "effects" on partner countries; free movement of labor is not provided for; and rights of establishment are absent or, in the case of EFTA itself, extremely limited.

This has meant that Europe's free trade areas are largely self-governing: they require no administration *per se*. They merely provide the framework for integration and the market does the rest. Canada and the United States would do well to note that market-based integration is essentially a simple proposition, but that free trade between sectors subject to extensive market-intervention policies either produces unacceptable distortions or requires the development of *common* intervention policies. This is not a simple proposition, as the experience of the European Community's Com-

[1]Switzerland's golden rule for handling embargoes and sanctions imposed by its trading partners against other countries for political reasons consists of two elements: it refuses to participate in such measures, while at the same time guaranteeing that trade with the target country will not be allowed to grow — as neutral a stance as possible in the circumstances.

mon Agricultural Policy has shown.[2]

EFTA has demonstrated, moreover, that the harmonization of laws and even of technical regulations is not necessary. A fair degree of free trade can be achieved without any effort in this direction at all, although economies of scale — one of the principal "dynamic" effects of integration — may have to be sacrificed. Recent developments in the EC suggest a neat "federalist" solution — in the sense of combining unity with diversity — to this problem. If this approach ever gets off the ground, it will put different regulatory systems into competition with each other, allowing the market to select the optimum rule. Canada and the United States can, in fact, choose between three alternatives here. They could decide to retain their respective technical regulations and sacrifice the potential economies of scale due to a larger market — the loss here being mainly Canada's; they could decide consciously to harmonize — an experience that the EC has found less than rewarding; or they could attempt the federalist approach. Whether or not this would be viewed as a serious erosion of sovereignty is impossible to predict in advance and presumably would vary from product to product and from sector to sector. But at least the process would make obvious the fact that sovereignty is a "good" that has to be paid for in terms of lost economies of scale.

Another factor that has helped to make the process of European economic integration relatively smooth and free of serious problems of adjustment has been the length of the overall transition period. No one would wish anyone else to pursue the tortuous path that Europe has taken. In particular, the parallel but separate evolution of EFTA and the EC in the 1960s undoubtedly produced costly distortions and much trade diversion. But the story has had a happy ending — after 30 years. Canada and the United States should not, perhaps, try to accomplish everything at once. A basic framework allowing for free trade in industrial goods would be a reasonable starting point — and the rest could follow in due course. Even this first step would entail substantial structural adjustments, but, as argued above, there is every reason to believe that the "pain" tends to be exaggerated, especially when one is discussing competition

[2]This can be viewed as an instance of the Lipsey and Lancaster theory of the second best, which states that if it is impossible to satisfy *all* optimum conditions, the satisfaction of *some* will lead to an uncertain outcome in welfare terms. In the case of agriculture, however, one is in a third- or fourth-best world where, if no optimum conditions are met *except* for free trade, chaos is the most likely outcome.

between countries at equal levels of economic development. However, there is no point in making the process of structural adjustment harder than necessary. Economic integration is much more a process than a state of affairs. Diving into the deep end of the swimming pool requires courage and entails some risks.

On a more technical level, the EFTA experience has shown that origin rules can be devised that are not too onerous to administer. One lesson stands out quite clearly in this respect: it is important to offer economic agents a choice of qualifying rules. The original EFTA rules of origin achieved this by offering firms either the process criterion or the value-added criterion. By all accounts, the current origin rules, which hardly permit any element of choice, are more costly to meet. An element of choice is important because government officials devising the origin rules in the first place cannot judge what the cost of complying with them is likely to be. By offering an alternative, they introduce a small but welcome market-based selection criterion.

Are Canadian and U.S. tariffs at the limit of the acceptable level of dispersion for the successful operation of a free trade area? The answer cannot be ascertained *a priori*. As mentioned above, EFTA was "lucky": the level of dispersion was low, and where it was not, geographic remoteness discouraged direct and indirect trade deflection. Points where tariff dispersion is high, especially for intermediate goods, need to be carefully monitored by the high tariff country in a free trade area, which runs the risk of unnecessarily burdening otherwise efficient sectors. In fact, Canada and the United States should take the opportunity offered by the current Uruguay Round of multilateral trade negotiations to bargain down their tariff "peaks" with the EC or Japan; their potential free trade area would be the healthier for it.

Formal dispute settlement procedures have rarely been used in EFTA or in the EFTA-EC free trade agreements, but problem solving is, of course, continuous and is the stuff of which regular meetings at the level of officials is made. Dispute settlement between two members of a group of countries of roughly equal size can take the form of peer group monitoring, and this is the essence of dispute settlement in the EFTA context on the rare occasions where no solution is found bilaterally. Dispute settlement in a bilateral setting, however, can only take the form of joint agreement and compromise; there is no "second stage" procedure. This situation is

rendered all the more acute when the parties are of vastly differing size, as is the case of the EFTA countries in the context of the bilateral free trade agreements with the EC or as would be the case in a Canadian-U.S. arrangement. For the smaller partner, there is no doubt that an impartial panel procedure — rather like that of the General Agreement on Tariffs and Trade — would be a desirable "second stage" for achieving the settlement of bilateral disputes. Canada might try to press for such a system, which ultimately would also be in the interests of the United States, since there would be some chance of thereby depoliticizing disputes, or at least putting them on a semijudicial footing.

In practice, disputes in a free trade agreement are most likely to arise because of nontariff barriers. This is why clear rules are necessary on the principal sources of nontariff barrier protection, namely, government subsidies, government procurement, antidumping and countervailing measures, private restrictive practices, and technical barriers to trade. The first three of these promise to be difficult issues to resolve in the Canadian-U.S. context. They are, of course, linked: discriminatory government procurement can be used as a form of hidden subsidy; countervailing duties are the deterrent used against public subsidies; and antidumping duties are among the remedies for private distortions of competition.

The EFTA and EFTA-EC experience suggests that a pragmatic approach, based on an effects doctrine, can be used instead of one based purely on legal criteria. But each grouping needs to find its own solutions. In particular, the legal approach favored by the United States is likely to govern any Canadian-U.S. trade system, and the EFTA experience is unlikely to be of much help or relevance in this domain.

In the field of public procurement, Canada is likely to run across the problem that any agreement to open up government purchasing on a reciprocal basis is bound to appear as an unequal bargain, favoring the smaller partner. The EFTA countries have encountered this problem in their relations with the EC; there is little they can do about it save to emphasize that the real gain takes the form of increased competition, from which both parties gain. Exactly the same point has to be brought home to lower levels of government in a federal state, which have to see the international obligations entered into on their behalf by the federal government as an oppor-

tunity to act more wisely, and not as an infringement of their right to act independently, but often foolishly.

As discussed above, private firms sometimes can also act in a protectionist manner, favoring local suppliers, refusing to do business with newcomers, and so forth. Generally speaking, competition can be relied on to reduce the scope of such anticompetitive behavior, and antitrust laws can be devised to complement what market forces alone cannot quite accomplish — or so runs the argument. If the Canadian-U.S. economic "space" is adequately covered by the two countries' respective antitrust laws, no explicit treaty provisions are needed. If, on the other hand, the two legal systems differ substantially, then a unifying principle along the lines of EFTA's Article 15 would be useful, just to ensure that private restrictive practices that distort free trade between the two countries can be discussed and dealt with at the diplomatic level.

A final word of encouragement: the European experience suggests, and theoretical considerations confirm, that free trade is compatible with an amazing degree of diversity. In fact, one only has to look within federal states to see just how much diversity survives after decades, if not centuries, of economic unity. The harmonization of laws is simply not necessary. Sweden can retain its extensive social welfare system — and the high level of taxation that goes with it; Switzerland can remain at the other end of this spectrum, with a maximum of self-help and low levels of taxation; Austria can run its economy on largely state-owned lines; Finland can retain its special relationship with the Soviet Union. In short, as Harry Johnson, Paul Wonnacott, and others have argued for many years,[3] it is quite unnecessary to harmonize the basic legal frameworks of countries. If a country's institutional and legal set-up burdens it with high costs, competition with other societies with lighter regulatory and tax burdens will show up in an equilibrating movement in the exchange rate — not a costless affair by any means, but a fair enough price to pay for one's independence, sovereignty, or whatever one wants to call it. If the price is too high — well, change the regulatory environment. The point is that the locus of

[3]See, for example, H.G. Johnson, P. Wonnacott, and H. Shibata, *Harmonization of National Economic Policies under Free Trade*, Canada in the Atlantic Economy 3 (Toronto: University of Toronto Press for the Private Planning Association of Canada, 1968); or H.G. Johnson and M.B. Krauss, "Border Taxes, Border Tax Adjustments, Comparative Advantage, and the Balance of Payments," *Canadian Journal of Economics* 3 (November 1970): 595–602.

sovereignty does not change; it remains with the country, its government, and its electorate. They remain free to choose.

In short, economic integration does not imply the loss of political sovereignty. All it implies is the acceptance of the function of competition as a method for weeding out economic inefficiency and promoting the efficient, low-cost, innovative elements in the economy. It is basically a down-to-earth business matter, at the end of which people can look forward to higher incomes and cheaper products. The apparent "costs" — that is, the weeding-out process itself — *are* the real gains, in the long term. It is a question of what kind of economy one wants to bequeath to the next generation. That the prospect of free trade between Canada and the United States should inspire fear of immense structural problems is encouraging: it indicates that there is every reason to believe that it would generate substantial gains! Yet, if the European experience is anything to go by, the process of adjustment is unlikely to be traumatic. The acceptance of competition is the key.

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